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INTERNATIONAL ECONOMIC SITUATION: The Japanese central bank absorbed less than \$300 million on the Tokyo exchange market yesterday, down from \$600 million on Monday and \$700 million on Tuesday. Finance Ministry officials stated that the market would be open again today.

Despite statements that the government will maintain the present yen-dollar rate, signs of flexibility are beginning to appear. Even though the Japanese probably intend to maintain the present rate until they have some indication of European intentions, Prime Minister Sato reportedly has asked the Finance Ministry to study the possibility of widening the margin within which the dollar would be allowed to fluctuate. Any adjustment in the exchange rate would be much easier for the beleaguered Sato government if it appeared to be the inevitable result of depreciation of the dollar on European exchange markets, thus avoiding the impression that Tokyo is bowing to pressure from Washington.

The search by the EC finance ministers, meeting in Brussels this afternoon, for a mutually acceptable common policy vis-a-vis the US dollar has been handicapped by the refusal of Paris to float the franc. The EC monetary committee had concluded earlier that a coordinated float of the five EC currencies against the dollar would be the most likely course of action, but the French delegate had then been unable to speak because his government's official position had not yet been determined. The French will table an alternative proposal involving the establishment of a dual rate system, similar to that practiced with some success by the Belgians. Under such a scheme, a floating exchange rate would apply to capital transactions, but central banks would continue to support fixed dollar - EC currency parities for commercial transactions.

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A Bonn Foreign Office official maintains that West Germany still holds that the EC should move promptly to act in cooperation with the US and should avoid any retaliatory measures. Both Economics Minister Schiller and EC Commissioner Dahrendorf, however, have hinted that "protective" measures, such as subsidies to certain export-oriented industries, might be in order.

A Canadian delegation, headed by Finance Minister Benson, is scheduled to arrive in Washington today hoping to obtain exemption from the ten-percent import surcharge. The US Commerce Department estimates that 23 percent of Canada's exports to the US are affected by the surcharge.

The strong international reaction against the surtax indicates that the US will be subject to rough questioning when this issue comes up in the GATT council, tentatively scheduled for 24 August. A high GATT official believes the council will act to have a working party examine the question with GATT Director General Long possibly serving as chairman. A GATT decision that the surcharge is warranted on balance-of-payments grounds could constrain other countries from retaliating against the US by withdrawing equivalent tariff concessions.

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CHILE: Extremists are again challenging the low-risk, cautious policies of President Allende and the Communists.

The Movement of the Revolutionary Left (MIR) is stepping up its effort to prove that violence is the only effective route to revolution and continues to preach that Allende's preference for constitutional channels obstructs progress to real socialism. The MIR has led frequent illegal armed seizures of farms and factories in recent months and boasts of inroads in the armed forces, where officers reportedly are concerned over rumored stockpiling of arms by the revolutionary group.

The powerful Communist Party (PCCh) considers the MIR a dangerous enemy to its own political influence and believes the MIR's insistence on the inevitability of armed struggle could provoke a rightist or military coup attempt against the Popular Unity (UP) government.

The rivalry is also one aspect of the dissension between the PCCh and its chief rival and partner in the UP, the Socialist Party. Some Socialists were original sponsors of the MIR. The argument surfaced again when Socialists defeated a PCCh attempt to prevent the use of the Chilean Trade Union Confederation building to honor a top MIR leader who died this week. The ideological and political struggle between the PCCh and the MIR has recently intensified in the labor field, which the PCCh considers its particular bailiwick.

Allende's own growing estrangement from the MIR, which he once hoped to co-opt by encouragement, has resulted in stronger police action against MIR-led activists and in differences with some of his hard-line fellow Socialists.

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BARBADOS: Prime Minister Barrow's ruling Democratic Labor Party (DLP) may face a strong challenge to its ten-year reign in the general election scheduled for 9 September.

A number of prominent political figures, primarily from the DLP, have announced plans to retire. In addition, recent changes in the electoral process and in the electoral districts mean that the DLP and its major opposition, the Barbados Labor Party, will be more equally matched, and greater emphasis will be placed on the candidate, rather than on the party.

Both parties are traditionally responsible socialist parties with remarkably similar orientation. They have each presented a slate of candidates composed primarily of young barristers and businessmen who reflect this moderation. There is no organized radical challenge, although the minuscule People's Progressive Movement may field a few candidates.

Election jitters were probably the reason behind an emotional speech by Barrow in June in which he attacked the US and Great Britain for alleged meddling in the internal political affairs of Barbados. The unusual outburst appears to have been an attempt to discredit opposition leader Bernard St. John by linking him to the vaguely defined interference. Barrow charged that St. John had been asked by a New York foundation to comment on a "confidential" report on Barbados before the report had been submitted to the cabinet. The report allegedly was given to St. John by the Twentieth Century Fund and was said to have concerned a survey by the Inter-American Development Bank. Although the incident died down after opposition denials, similar charges can be expected as the campaigning gains momentum.

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AUSTRIA-SWITZERLAND: Austrian and Swiss officials are considering greater cooperation in arms development and defense matters.

The Austrian press has revealed that Swiss President Rudolf Gnaegi proposed that an arms pool be established by Switzerland, Austria, and Sweden.

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25X1 [redacted] The proposal also would involve a further synchronization of arms development including the creation of an antitank system. Austrian Chancellor Bruno Kreisky has described the proposal as "very interesting" and said it deserves further government study.

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25X1 [redacted] the two countries are exploring the possibility of allowing Swiss military units to train at Austrian maneuver areas, and both countries are already utilizing military equipment produced by the other. Although Bern recently rejected the Swedish SAAB 105 fighter for its air force, Sweden's sophisticated armament industry would provide an additional source of military technology which both the continental neutrals could tap. The Austrians are especially dependent on outside sources, and the Swiss would welcome this type of interchange because Switzerland's laws restrict the sale of its manufactured arms to governments that are stable and not likely to be involved in war.

More importantly, Gnaegi's proposal reflects Bern's concern over the decline in Austria's military credibility since Kreisky's army reform legislation reduced the term of military service from nine to six months. The Swiss have repeatedly irritated Kreisky by expressing their fears of a "military vacuum" in Austria, but the Austrian chancellor may find Bern's offer useful to counter similar criticism from domestic critics prior to the national elections scheduled for 11 October.

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MALAYSIA - COMMUNIST CHINA: Malaysia's incipient rapprochement with Communist China may well receive a new impetus from the visit of a Communist Chinese trade delegation next week.

The delegation, led by a senior Chinese official, presumably plans to settle the details of the previously negotiated sale of Malaysian rubber to Peking. Other possible trade items, principally oil and timber, will also be discussed.

Although ostensibly confined to commercial matters, the talks are bound to have political overtones, if only because this is the first official Chinese delegation to visit Malaysia. Kuala Lumpur has indicated its interest in improving relations with Peking, but probably will not initiate any official political negotiations at this time. From the Malaysian point of view, China's continuing propaganda support for insurgents in West Malaysia remains a major block to any diplomatic ties.

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PERU: The government has threatened to break diplomatic relations with France unless the present series of nuclear tests in the Pacific is suspended. According to press reports, on 17 August President Velasco informed President Pompidou that Peru would "deplore" a break but would be forced to take such action if the protest were ignored. Chile, as well as some Asian countries, has protested the French tests, but the Peruvian initiative is the strongest reaction so far. Two more explosions are scheduled for next month, and the French are unlikely to change this program because of the Peruvian protest.

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VENEZUELA: Congress' approved version of President Caldera's bill for public sector development of gas exports may not be as damaging to the petroleum industry as originally feared by the oil companies. According to the final provisions, the government apparently will take only gas the companies are flaring off (burning). Government compensation to the companies, however, will be limited to their costs in collecting the gas to be turned over. Although passage of the bill is a political gain for Caldera, he still may decide to return the legislation to congress because of amendments added by opposition political parties. The amendments could restrict the government to building only one gas plant instead of the two Caldera had proposed, which would seriously weaken the project's viability.

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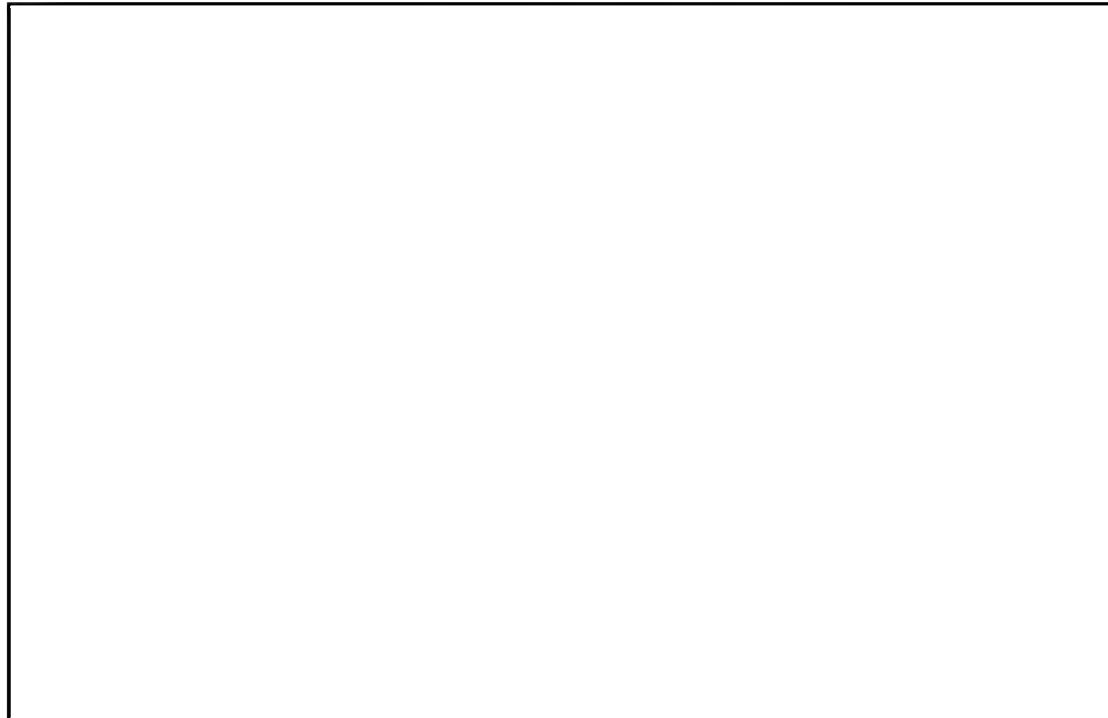
ARMS CONTROL: The nonaligned participants in the Geneva disarmament talks have responded to the US-USSR draft convention curbing biological weapons (BW) in a more positive manner than had earlier seemed likely. Their proposed amendments, formally introduced Tuesday, still seek to obligate the superpowers to negotiate an agreement on chemical weapons (CW), a commitment the nonaligned have long desired. The paper does not, however, challenge the US contention that the Geneva Protocol of 1925 does not ban the use of tear gas and herbicides in war. Because of the favorable nonaligned attitude, the US and Soviet delegations plan to recommend some of the nonaligned amendments to the draft BW convention for consideration in their capitals.

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